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Determining Institutional Investors' Dynamic Asset Allocation Strategy with Prospect Theory

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Abstract

With the dramatic increase in institutional ownership of equities over the past three decades, institutional investors have become increasingly important as equity holders in financial markets. It is surprisingly that institutional investors do play little role in financial theory. Traditional von Neumann-Morgenstern expected utility theory argued that the utility function of an individual should base on total wealth she has rather than on the changing wealth she invests. It is not the case for institutional investors since institutional investors do indeed have no the problems of consumption and bequest, and it is subject to a particular kind of risk represented by the withdrawals from and contributions to the managed assets that can be described by its' past performance. Hence, the classical consumption-investment problem is not appropriate for institutional investors. Measuring the utility of institutional investors by value function of prospect theory, we find that the dynamic asset allocation policy of an institutional investor is direct proportional with the change of total net managed assets (sum of changing wealth and net flows), and inversely proportional with both his total net managed assets and relative risk aversion coefficient. Besides, there is a very interesting phenomenon that no matter what the loss aversion coefficient is, institutional investor would make the same decision.

Key words : Dynamic asset allocation; Institutional investor; Prospect theory;
Investment opportunity set

中文摘要：動態資產配置；機構投資人；展望理論；投資機會集